STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 16th Floor
Sacramento, California 95814

ADOPTION OF REGULATION ON AN EMERGENCY BASIS PURAUANT TO CALIFORNIA GOVERNMENT CODE SECTION 11346.1(b)

ER-2006-00001 **November 3, 2006**

A. Emergency Regulation Text/Form 400

Attached as Exhibit 1.

B. Agency Express Finding of Emergency

California Insurance Commissioner John Garamendi (the "Commissioner") hereby amends and adopts on an emergency basis Title 10, Chapter 5, Subchapter 7.7, Sections 2697.6 and 2697.61 of the California Code of Regulations (CCR) regarding Earthquake Policies, Coverage Types and Limits and Additional Requirements for Offer of Optional-Limits Basic Residential Earthquake Insurance Policies, respectively. Pursuant to California Government Code Section 11346.1, the Commissioner has determined that an emergency exists and that the adoption of this regulation on an emergency basis is necessary for the immediate preservation of the public peace, health, safety, and general welfare of the people of the State of California.

C. Agency Statement of Specific Facts Showing the Need for Immediate Action

The California Earthquake Authority ("CEA") writes earthquake insurance. It was established by the Legislature in response to the widespread unavailability of homeowners and earthquake insurance after the 1994 Northridge earthquake. The CEA carefully considers the purpose of its formation when shaping its fundamental objectives, one of which is increasing the availability of earthquake insurance for California renters, condominium owners, and homeowners. As a public instrumentality of the state, the CEA is governed by a board of elected state officials and managed by a staff of primarily civil servants; the CEA is funded largely with private monies.

The CEA enabling statute authorizes the CEA to write basic residential earthquake insurance, and by regulation, the basic product has been divided into a "base" product (the CEA's statutory "mini-policy," "base program," or "base limits policy") and an "optional-limits" product, usually called the CEA's Supplemental Limits Program. The CEA believes that while the base limits policy is quite helpful and would cover, for example, a house and a small amount of personal property and living expenses, it has really been the Supplemental Limits Program that has driven CEA success in policy sales for several years. This is why, in an effort to increase overall sales, the CEA has actively marketed the Supplemental Limits Program products. The

CEA sees the Supplemental Limits Program as key to its ability to increase the availability of earthquake insurance for Californians.

The Supplemental Limits Program is supported almost entirely by reinsurance. In fact, for 2007, its reinsurance amounts to almost $600 million in a reinsurance contract that responds to losses in excess of the CEA's $50.3 million retention. The 2007 reinsurance program dates to February 2006, when the CEA Governing Board adopted the CEA's 2007 base program and Supplemental Limits Program financial structures and directed CEA staff to obtain reinsurance commitments consistent with those structures. The CEA immediately began the complex process necessary to obtain the reinsurance, contacting some 171 reinsurers in 15 countries for bids.

By June 2006 the CEA had obtained certain reinsurance commitments but for a smaller claim-paying capacity than in prior years. The problem was a reinsurance market growing harder by the day, spawned primarily by reinsurers' need and desire to recoup huge losses from the hurricanes of 2004 and 2005 in the Southeastern United States (Katrina, Wilma, Rita). Every insurer looking to reinsure exposure experienced the hard market, but as one of the world's very largest purchasers of property catastrophe reinsurance, the CEA acutely felt the climbing prices. Even with less reinsurance than desired and at a considerably higher cost than desired, the reinsurance commitments that were obtained included as much reinsurance coverage as the market would permit at an acceptable price, and on June 27, 2006, the Governing Board authorized placing the reinsurance.

This emergency arises out of that sharp increase in the cost of catastrophe reinsurance for the 2007 contract year. Because regulations require the Supplemental Limits Program to be financed separately from the base program, the Supplemental Limits Program's sharply increased reinsurance costs mean that Supplemental Limits Program premium revenue will not be received in sufficient time to allow the CEA to pay annual reinsurance premium installments when due. Without reinsurance, the Supplemental Limits Program cannot exist; and, without the Supplemental Limits Program, the CEA believes that it would lose its key to policy sales.

CEA staff has determined that a two-step plan would allow the Supplemental Limits Program to continue: (1) Supplemental Limits Program rates would have to rise by 32.5 % over two years, and (2) to cover expense obligations until the full effect of the rate increase was achieved, the CEA would have to temporarily transfer capital from the base program to the Supplemental Limits Program. Current regulations do not allow the CEA to make such a capital transfer.

On August 24, 2006, the CEA Governing Board approved the plan and authorized the CEA to petition the Insurance Commissioner for a regulatory change to allow the emergency capital transfer authority required to continue the Supplemental Limits Program. The regulatory change must be completed before January 1, 2007, the effective date of the CEA's 2007 reinsurance contract. Otherwise, CEA will be forced to discontinue its Supplemental Limits Program coverages in early 2007, and all CEA policies that include Supplemental Limits Program coverages will be renewed with only base limits policy coverage. At the same time, the

CEA will be forced to cease offering Supplemental Limits Program options to new and existing policyholders.

It is estimated that just over 12% of California households have earthquake insurance. A decrease in this already low penetration rate would reduce the number of Californians able to afford to rebuild after a devastating earthquake. If the Supplemental Limits Program becomes unavailable, the CEA predicts it will lose a significant number of base limits policyholders. In the event of a major earthquake in California, this reduction in policyholders would exacerbate the economic devastation caused by the earthquake.

> Government Code Section 11346.1(b) allows a state agency to promulgate emergency regulations as follows: '[I]f a state agency makes a finding that the adoption of a regulation or order of repeal is necessary for the immediate preservation of the public peace, health and safety or general welfare, the regulation or order of repeal may be adopted as an emergency regulation or order of repeal.'" *Doe v. Wilson*, (1997) 57 Cal. App. 4th 296, 305.
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> "[T]he term "emergency" has been given a practical, commonsense meaning in the California case law: "[E]mergency has long been accepted in California as an unforeseen situation calling for immediate action. [Citations.] This is 'the meaning of the word that obtains in the mind of the lawyer as well as in the mind of the layman.'" *Id.* at 306.

Here, the steep and sudden increase in reinsurance rates that developed in spring 2006 while the CEA was in the reinsurance market for 2007 is the "unforeseen situation" that compels immediate action. Because the reinsurance rates have jumped, the CEA must move quickly to ensure that the Supplemental Limits Program can continue. Without amending the regulations, the CEA cannot transfer capital from the base program to the Supplemental Limits Program. And without such a transfer on a timely basis - which can be afforded only by emergency regulations - the CEA Supplemental Limits Program will end.

D. Authority and Reference Citations

Authority: Sections 10087, 10089.5(c), 10089.11, 10089.20 and 10089.26(a)(1), Insurance Code.

Reference: Sections 10089, 10089.11(a), 10089.28(b) and 12921, Insurance Code.

E. Informative Digest

The California Earthquake Authority ("CEA") was established by Legislative enactment of Chapter 8.6 of Part 1 of Division 2 of the Insurance Code (Insurance Code sections 10089.5 et seq.). Certain aspects of the CEA's operations are identified in Insurance Code Section 10089.11 requiring the promulgation of regulations. In accordance, the Commissioner promulgated certain regulations under Title 10, Chapter 5, Subchapter 7.7 [California Earthquake Authority] of the Code of Regulations (CCR).

Under existing law, no mechanism exists whereby the CEA may transfer base-capital funds for optional-limits program financial support. The Department proposes to amend Section 2697.6(e) and 26970.61 in order to provide such a mechanism. Under the proposed amendment, Section 2697.6(e) will be changed to allow the CEA to make intra-Authority transfers. Furthermore, subsections (b)(iii) through (b)(v) will be added to Section 2697.61. Subsection (b)(iii) will permit transfers of base-capital funds for Supplemental Limits Program financial support provided that the Governing Board makes certain findings regarding the appropriateness of the loan and also provided that the loan is reimbursed within three years. Subsection (b)(iv) provides a formula for the calculation of the maximum transfer of capital from the base program. Subsection (b)(v) sets forth circumstances barring such a transfer and sets an expiration date for making such a transfer.

F. Specific Agency Statutory Requirements

In compliance with California Insurance Code Section 12921.7, on or about October 27, 2006, notice of the proposed emergency action was mailed to every person, group, or association who had previously filed a request for notice of all regulatory actions with the Department of Insurance, as well as to every person, group, or association who had previously filed a request to receive only notices of regulations specifically involving Property & Casualty, Rate Regulation, Discrimination and Underserved Communities. The Notice of the Proposed Emergency Amendment with proof of mailing is attached as Exhibit 2.

G. Local Mandate Determination

The Commissioner has determined that the regulatory action imposed herein will result in no program mandates on local agencies or school districts.

H. Fiscal Impact Estimate/Form 399

The Commissioner has determined that the regulation will involve no costs or savings to any State agency, no reimbursable costs to local agencies or school districts under Part 7 (commencing with Section 17500) of Division 4 of the Government Code, no nondiscretionary costs or savings to local agencies, and no costs or savings in federal funding to the State.

Form 399 is attached as Exhibit 3.